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March 25, 2004

VIA ELECTRONIC FILING

Ms. Marlene Dortch, Secretary
Federal Communications Commission
445 12th Street, SW
Room TWB-204
Washington, DC 20554

Re: *Framework for Broadband Access to the Internet Over Wireline Facilities*, CC Docket No. 02-33; *Sunset of the BOC Separate Affiliate and Related Requirements*, WC Docket No. 02-112

Dear Ms. Dortch,

On Wednesday, March 24, 2004, Steve Garavito and the undersigned, AT&T, and Michael Hunseder, Sidley Austin Brown & Wood, representing AT&T, met with Brent Olson, William Dever, William Kehoe, Michael Carowitz, Jon Minkoff, Pamela Megna, and Will Cox of the Wireline Competition Bureau's Competition Policy Division. At this meeting we discussed AT&T's February 13, 2004 written ex parte submission in the above-captioned proceeding opposing requests by Verizon and BellSouth to exempt various Bell-provided services from existing cost allocation rules. In addition, we were asked how the Commission's recent Order in the Operate Independently proceeding (Report and Order, WC Docket No. 03-228, *Section 272(b)(1)'s "Operate Independently" Requirement for Section 272 Affiliates*, released Mar. 17, 2004) would impact our views on this matter. I have attached an outline summarizing AT&T's arguments as presented during our meeting.

Sincerely,

ATTACHMENT

cc: M. Carey, W. Kehoe, M. Carowitz, P. Megna, W. Cox, J. Minkoff, W. Dever, B. Olson

BELL REQUESTS FOR EXEMPTIONS FROM APPLICATION OF COST ALLOCATION RULES

- Verizon seeks an exemption of "broadband" services from cost allocation rules in the event those services are "reclassified" from Title II to Title I services, *i.e.*, permission to mix costs of broadband with costs of remaining regulated services.
- BellSouth seeks reversal of the rule that incidental interLATA services are subject to the cost allocation rules after § 272 requirements sunset, *i.e.*, permission to mix the costs of these services with regulated local services.
- Both requests are foreclosed by law and sound policy: it is fundamental that ILECs, so long as they have market power over local services, have the ability and incentive to misallocate costs. AT&T 2/13/04 *Ex Parte* at 2 n.4. And cost allocation rules perform a vital function in ensuring that costs of regulated services are not inflated by costs of other services including broadband, interLATA. AT&T 7/31/03 *Ex Parte* at 2-3.
  - Sections 254(k) and 271(h) place a "continuing obligation" on the Commission to ensure that necessary cost allocation rules are in effect; Commission previously found that existing cost allocation rules fulfilled this obligation; now, it cannot eliminate its existing rules until it determines what cost allocation rules apply. AT&T 2/13/04 *Ex Parte* at 8-10.
  - Price caps do not remove incentives to misallocate costs (*id.* at 2-6);

    --price caps do not entirely sever the link between cost and price, because many states retain sharing mechanisms or rate-of-return;

    --price caps necessarily are based on indices and productivity targets and, as the Supreme Court concluded, do not "eliminate gamesmanship" because ILECs can misallocate costs to obtain changes in targets;

    --cost misallocation can lead to higher UNE prices
  - The Bells have made no showing that cost allocation is burdensome in these contexts (*id.* at 6-8);
- The recent Commission decision eliminating OI&M requirements only strengthens the case for retention of the cost allocation rules:
  - In 1996, the Commission found difficulties in allocating costs of shared OI&M services, and to avoid the necessity of engaging in cost allocations, adopted a broad structural ban against shared OI&M that prevented any shared costs from being incurred in the first place.
  - In 2004, the Commission determined that this broad ban was not necessary, but it did so precisely because it found that "existing non-structural safeguards" – including its cost allocation rules – are "sufficient to provide effective and efficient protections against cost misallocation." *Order* ¶ 18.

- Specifically, the Commission found it "will be able to effectively monitor the performance of the BOC provision" of shared services through application of "the Commission's affiliate transaction and cost allocation rules." *Id.*
- The Commission also determined that it could eliminate its structural OI&M safeguard only after it found that the Bells "will continue to be obligated to maintain accounting procedures that protect against cross-subsidization" *Id.* ¶ 20.
- Further, the Commission did not adopt the Bells' view that price caps alone are sufficient to preclude cost misallocation; rather, price caps only *reduce* the incentive to misallocate costs. It is the combination of price caps with "other non-structural safeguards," like the cost allocation rules, that help to prevent misallocation. *Id.* ¶ 22.
- Finally, the Commission necessarily concluded that the cost savings associated with eliminating its structural ban on shared OI&M services were more significant than the costs associated with Bells' "adherence to our [other] structural and non-structural rules, including the cost allocation rules" *Id.* ¶ 25. In other words, the costs of applying cost allocation rules are not significant and are not outweighed by the benefits they provide – otherwise, the Commission would have eliminated those rules, too.

♦ The OI&M *Order* thus affirms that non-structural safeguards, and specifically the cost allocation rules, are one of the necessary components of rules to prevent cost misallocation in the absence of broad structural protections such as an outright ban.

♦ The Commission can hardly expect to sustain its OI&M *Order* on appeal if it immediately turns around and creates gaping exceptions to rules that it relied upon in repealing the OI&M safeguard.

- It would be inconsistent with the OI&M *Order* if the Commission here were to conclude that cost allocation rules were not necessary to prevent unlawful cost shifting.
- The Commission could not, in light of the OI&M *Order*, conclude that price caps alone are sufficient to prevent cost misallocation.
- The Commission also could not determine, in light of the OI&M *Order*, that costs of applying cost allocation rules are significant or outweigh the benefits provided by the rules. AT&T 2/13/04 *Ex Parte* at 7-8.

♦ These conclusions are all the more true for Bells' provision of broadband services, for which there is no requirement that they provide via a separate affiliate. Thus, there are *no* structural safeguards required by the Act that (as was the case with § 272 and OI&M, *see Order* ¶¶ 19, 21, 23) would help to protect against cost misallocation.

♦ For broadband, the only protections pointed to by the Bells are price caps. But the Commission has never found that price caps, by themselves, eliminate the incentive and ability to misallocate costs, and Congress, in §§ 254(k) and 271(h), in effect rejected that view by requiring the Commission to implement necessary cost allocation rules even though price caps had long applied.

♦ Bells are seeking a fundamental change in classification of broadband, so that it is deemed non-regulated. If that view is accepted, then the change necessarily means that the treatment of broadband costs must be revised so that costs are not lumped in with regulated services costs.